Bond Case Briefs

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Why Are Closed End Bond Funds On Sale Like Its Black Friday?

Many closed end bond funds ("CEFS") are trading at large discounts to net asset value ("NAV").

I selected Western Asset Managed High Income Fund for this chart, but there are many closed end bond and loan funds (including funds invested in Municipal Bonds) that exhibit similar patterns.

We have seen the discount to NAV (the yellow line) increase. This has largely been due to the price performance of the CEF, as the underlying NAV has been reasonably stable as of late.

The most common reasons I hear for the discount to NAV on so many CEFS are:

- Fear of the Fed raising rates and its impact on bond prices
- Concerns about the leverage the funds use in a rising rate environment
- Nervousness over the asset quality of the fund's holdings and true value of the fund
- Tax Loss Harvesting

I will attempt to address each of these reasons in turn and will add one additional reason to consider deeply discounted funds.

A December Rate Hike and Bond Prices

According to Bloomberg, the market is pricing in a 72% chance that the Federal Reserve Open Market Committee will raise the Federal Reserve Fund Target Rate range by 0.25% in December.

I wanted to be explicit about what rate is being hiked because it is crucial to understand that the Fed has limited ability to set longer term rates. The treasury market yield curve for bonds with maturities 2 years or less is heavily influenced by the Fed Funds Rate and by the messages the Fed sends. As you move further out the curve, to 10 years and beyond, rates are influenced by longer term policy indications and fears (or hopes) of growth and inflation.

With the rate hike so well telegraphed, there is little reason to believe that bond yields across the curve will move by much. Any change in longer term yields are more likely to more based on the tone of the Fed meeting – which will likely be very dovish and show that they will be extremely cautious in terms of future interest rate hikes.

So based solely on the hike, there should be little movement in bond prices.

There is concern that the rate hike will cause the dollar to strengthen, causing yet more pressure on commodity prices, in turn hurting bonds of those producers. That is a possibility, but as we have seen time and time again, when something is so logical and widely anticipated, it rarely occurs. The market has had almost a year to digest the impact of the first rate hike, and the dollar (as measured by the DXY Index) is already at highs of the past 12 years (first reached in February).

So being concerned about further dollar strength is rational, it may already be priced in.

The Impact of Leverage

A rate hike will likely increase the cost of the leverage used by most CEFs. Assuming the fund borrows using short term rates (3 month LIBOR for example), without an interest rate floor, then the cost of those borrowings is likely to increase. That will impact the Net Interest for the CEF (Total Interest minus Cost of Funds).

For most funds that will have a very small impact on what can be distributed, as it will likely only be 0.25% and only on the amount of money borrowed (typically 25% to 33% of the funds size). I anticipate that cost will be around 0.1% in the first quarter of next year for most funds, which is small relative to dividend yields and current discounts to NAV.

So while the direct cost of increased borrowing costs is real, it is small relative to current dividend yields and NAVs for many funds. MHY, which does not use leverage, has a 9.5% dividend yield and 15.6% discount.

Leverage does amplify price moves in the underlying asset classes, but that is ongoing and has nothing to do with a change in rates. It also works in both directions, so any price increases in the underlying assets will also be impacted. Whether or not bond prices will increase or decrease from here is unknown, the impact of leverage on the return of the underlying assets cannot be ignored and bond prices could drop further, but the current discount to NAV can be a large offset over time.

Asset Quality

Much has been made about the difficulty in valuing and trading bonds. While that is true it can be overstated. According to TRACE data, the market has been averaging over $15 billion of investment grade bond trading on a daily basis for the past month. High Yield volumes are much smaller but not insignificant.

I like to look at the ETF's to judge how "well" a market is trading. **If a market is out of favor or very difficult to value, I would expect the ETF for that market to be trading at a discount to NAV.**

But that is not currently the case as the ETF's for Municipal Bonds, Investment Grade Bonds, and High Yield Bonds are all trading at a premium to NAV.

Asset Class	ETF	Premium
Municipal Bonds	MUB	0.2%
Investment Grade	LQD	0.0%
High Yield	HYG	0.5%
High Yield	JNK	0.5%
Leveraged Loans	BKLN	-0.2%

That premium to NAV should ease concerns that the asset class is "for sale". In fact the difference in the high yield market, where many of the CEFS trading at the largest discount to NAV invest versus the ETF's trading at a premium is striking.

Leveraged loans, which also have many CEFS, are a bit more concerning as the main ETF for that market continues to trade at a discount to NAV and experience outflows.

Tax Loss Harvesting

This can be a valid strategy, particularly if coupled with buying a similarly discounted CEF – to capture the tax loss without creating a wash sale issue (please talk to your accountant for any tax related issues).

That could be causing some selling pressure but that tends to dissipate as we near year end. Furthermore, we often see new allocations to fixed income in the first part of the year where investors tend to "annualize" the yield they can receive – not a strategy I condone as I believe fixed income should be managed throughout the year, but it is a flow that tends to occur with regularity so I would not want to ignore that.

So this is a real issue, but a temporary one that should be nearing the end of this year's flows.

Manager Buying

As we near year end, we could see some managers buy back shares of some of their most heavily discounted CEFS. I have spoken to several managers of CEFS and they all tend to start buying back shares to support prices in the 15% to 18% discount range (some types of funds start earlier). Managers do not like their funds to experience high discounts to NAV for prolonged periods as they feel it can reflect poorly on the manager.

So we are nearing levels on many funds, where another possible source of capital inflows could enter the market, supporting the trading price versus NAV.

Are CEFS the Doorbuster of the Market?

There remains a lot of risk in the bond market, but good managers can find value, and while we have all been trained to buy what retailers "discount" so far, we generally have the opposite tendency when it comes to markets. The discount to NAV for many represents fear, rather than the impulse to get a good deal.

For myself, I am not sure that the pain is over in the bond market, but well managed CEFS trading at a deep discount to NAV is interesting, especially when so many of the reasons we are seeing that phenomenon can be explained away.

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